Report to the Senate Finance Committee on Results from the Michigan Business Tax Impact Assessment Subcommittee

Members: Senator Mark C. Jansen (Chair), Senator Jud Gilbert, Senator Michael Prusi

as reported to Finance Chair Nancy Cassis and Committee Members

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BACKGROUND

Michigan's primary business tax, the Single Business Tax (SBT), was replaced by the Michigan Business Tax (MBT) in 2007, effective January 1, 2008. The Single Business Tax was the nation's only large-scale, value-added tax. The tax was designed in 1975 to replace six other business taxes in place at the time, hence the moniker, "Single Business Tax." The SBT was in effect from January 1, 1976 to December 31, 2007. Because of the unique value-added nature of the SBT the tax was the object of frequent litigation and amendment. Further, the tax had a number of anti-competitive characteristics that uniquely affected small and midsized entrepreneurs.

The MBT is also a unique tax and is a blend of a modified gross receipts tax (levied at a rate of .80 percent) and business income tax levied at 4.95 percent. While the MBT was designed to offer sizable advantages via specific credits to certain firms, particularly manufacturing firms, other firms are adversely impacted by the MBT. Further, there have been difficulties in computing the correct tax and in administrating the tax.

In the fall of 2007 a surcharge of 21.99 percent was added to the base MBT calculation. The surcharge was created to replace revenues that would have been generated by a sales tax on services. The services tax proved to be far too complex and burdensome, and the business community reluctantly conceded to the imposition of the surcharge. Despite the business community's overall preference for the surcharge over the services tax, the surcharge has increased the burden of the MBT significantly.

Primary Findings

The Michigan Business Tax Impact Assessment Subcommittee, made up of Senators Mark C. Jansen (Chair), Jud Gilbert and Michael Prusi, held four meetings in May of 2008 and took testimony from dozens of business owners and organizations on the impact of the Michigan Business Tax on their businesses. The scope of businesses and organizations testifying ranged from the Michigan Manufacturers Association and large manufacturing firms such as Herman Miller to family-owned restaurants, a small electronics repair business and several, small certified public accountant firms. Testimony was taken in Grand Rapids, Rochester, Saginaw and Gaylord. The committee also received testimony via mail.

In the most general sense the committee found that the burden of the MBT was several times greater than the burden of the SBT for many firms in varying industries. The "surcharge" proved to be painful for virtually every business that testified. Even manufacturers, which are generally benefiting from the structure of the MBT, indicated strong support for removal of the "surcharge". Further, the inclusion of sales and other taxes in the base of the MBT greatly harmed retail establishments—from small grocers and restaurants in western Michigan to RV sales and service centers in northern Michigan.

Testimony also generally indicated that compliance costs were quite high, particularly for small and midsized firms. Information from the Department of Treasury is spotty and often inadequate. Many small taxpayers were unaware that they qualified for the most obvious credits and deductions under the MBT. Many firms, for example qualified for the small business credit also know as the alternative credit.

Testimony indicated that the burden of the tax is so great and the shift of the incidence of the tax so impactful that many firms stated they could not hire needed workers, could not offer wage and salary increases, would have to scale back investment in Michigan and were put at a distinct competitive disadvantage to non-Michigan competitors. In the most dire testimony some individuals indicated that they were actively looking to leave the state.

An experienced certified public accountant in the Saginaw area indicated he did not feel that the state fully understood the impact of the tax. He testified that when "key individuals" leave the state they take the jobs and the entrepreneurial knowledge they possess with them. He indicated some of his "key" clients were seriously contemplating leaving the state entirely.

Surcharge

- The surcharge replaced a much-reviled sales tax on services (see background) and was negotiated with the business community in the fall of 2007.
- The impact of the surcharge is ***having a dramatic negative impact on midsized and large firms*** that don't have access to credits and that don't qualify for the small business credit.
- Manufacturers, while generally supportive of the structure of the MBT, advocate for the elimination of the surcharge and the sales tax from the gross receipts base. The Michigan Manufacturers Association, which gave testimony at all the committee's meetings, also support further work on relief from personal property taxes and simplification of the tax by utilizing cost of goods sold in lieu of "purchases from other firms" in the net gross receipts calculation.

The most direct strategy to address the surcharge is to eliminate it. Fiscal constraints, however, make this difficult. Phasing the surcharge out over a number of years mitigates the fiscal impact while providing business with tax relief over time. The following illustrates the fiscal impact of phasing out the surcharge over 3, 5 and 9 years beginning January 1st, 2009.

FISCAL IMPACT OF PHASING OUT MBT SURCHARGE				
Fiscal Yr.	Surcharge	3 years	5 years	9 years
2008-09	$687	($128.8)	($77.3)	($42.9)
2009-10	$700.7	(364.1)	(218.5)	(121.4)
2010-11	$714.8	(608.7)	(365.3)	(202.9)
2011-12	$729.0	(726.3)	(517.8)	(287.7)
2012-13	$743.6		(676.4)	(375.7)
2013-14	$758.5		(755.7)	(467.2)
2014-15	$773.7			(562.2)
2015-16	$789.1			(660.8)
2016-17	$804.9			(763.1)

Treasury Issues

- ***The Michigan Department of Treasury is not providing adequate information*** to taxpayers on complex tax compliance issues. Further, there are no instructions on the Treasury website to help taxpayers in any definitive fashion.

- The Treasury website calculator seems to be generating erroneous results.

We heard several small businesses indicate that the Treasury calculator was “way off”. In most of these instances the amount calculated indicated a result that was far above the amount actually computed by CPAs. In addition, comments made to the committee indicate that smaller taxpayers are having difficulty with various portions of the tax and some of this is mitigated as taxpayers get more information from treasury.

- The Department of Treasury is making interpretations of the law that are questionable and causing confusion among taxpayers. The Department has interpreted the deduction for materials and supplies in an extremely narrow fashion. This has caused significant confusion particularly in the construction industry. Further, these interpretations are not in line with what was commonly thought of as agreed upon during negotiations in 2007.

- Many taxpayers are extremely apprehensive concerning the possibility of penalties and interest being imposed by the Department of Treasury if their taxes are improperly computed.

Taxpayers universally requested reductions or an amnesty from penalties and interest for the initial year of the MBT.

Sales Tax in Base of Gross Receipts

- ***The inclusion of sales taxes and other taxes and fees in the base of the MBT is not reasonable by any standard of sound tax policy*** and is having a profoundly negative effect on several types of business, most notably retailers and gas station owners.

Cascading of the Tax

- Firms that hire a lot of services to provide a product are hurt by the cascading that occurs on the services side of the tax.

Trucking and logistics firms indicated that cascading of the tax was particularly harmful. In addition, a jet leasing company also indicated that cascading of services thru their business model caused a substantially increased liability under the MBT.

- Firms providing nursing care to the elderly indicated that the inclusion of Medicare and Medicaid in the base of the MBT would cause increased costs to the state over time and hamper their ability to provide care. In one case, a nursing care firm saw a multi-million dollar increase in tax that could have a potentially devastating impact on their ability to provide care for elderly patients.

Unitary Filing Problems

- The unitary concept is harming a number of family-owned businesses because they are exposed to the full weight of the MBT. These firms were typically able to file separately under the SBT but now must consolidate their filings under the MBT. These firms are seeing tax increases of several-fold.

On this particular point we heard testimony from the automotive repair industry and from the owners of several small businesses including owners of McDonald’s restaurants. The auto repair industry indicated that they employ approximately 50,000 people in Michigan and that on average they were getting a 225 percent increase in MBT over SBT liability.

- Affordable housing and community development groups indicated that unitary filing requirements and the timing of gross receipts increased their liability from $17,500 under the SBT to $180,000 under the MBT a ten-fold increase.

Property Tax Issues

- Businesses aren't aware that they qualify for property tax exemptions and credits.

Because tax bills will not be released until July of 2008 many taxpayers are presently unaware of the property tax relief they will receive under an exemption for commercial and industrial personal property.

- Many smaller manufacturers are finding that despite manufacturing for 30 or 40 years their personal property is not eligible as industrial personal property tax relief under the MBT. The problem seems to occur primarily because the local assessor has mischaracterized the property and the Department of Treasury is unwilling to characterize the property as industrial personal for purposes of the property tax credits and exemptions that are an integral part of the MBT.

A certified public accountant from the Bay City Area indicated that he had pervasive problems with Treasury concerning the characterization of industrial property.

Small Business Issues

- ***Business aren't aware that they qualify for the Small Business Credit*** and sufficient information is not being adequately communicated to these taxpayers from the Department of Treasury.

In every location several businesses came forward indicating that their MBT liability would exceed their SBT liability by several-fold. Upon the most cursory inspection it appeared that the vast majority of these firms would likely qualify for the small business credit, which is equivalent to an income tax of 1.8 percent. Firms qualify if they meet all of the three following criteria:

1. Gross receipts, usually total sales, must be less than $20 million annually.
2. Officer or owner compensation and director's fees, (including partners in a partnership and members of an LLC) must be under $180,000.
3. And finally, your adjusted business income must be less than $1.3 million.

As a note, family-owned business may be disqualified, if for example, a father and son earn over $180,000 and federal rules of attribution of stock ownership apply. Otherwise, however, most businesses that the committee encountered did qualify for the small business credit.

- Michigan-only firms that don't have access to credits are mystified by a tax policy that would punish them so severely. Many of these firms are seeing a tax increase of 200 percent to 600 percent.

- ***Real estate developers have experienced extremely large increases in liability over the SBT***. This is primarily because the MBT has no analogous offset like "purchases from other firms" for the acquisition of real estate.

Testimony from developers indicated that development in Michigan, particular in urban areas, would be stopped by the harsh treatment of the tax.

Fixing the MBT

Perhaps one of the most important decisions that policy makers have to make concerning the MBT is how to solve problems concerning the tax. Many problems can be solved on an ad hoc basis but the ad hoc "fix" is not universal, complicates the tax and adds to the perception, if not the reality, of the unfairness and arbitrary nature of the tax. Dealing with a fundamental structure of the tax, however, is more equitable but can be expensive or politically difficult. For example, testimony before the committee indicates that cascading on the services side of the MBT is a common problem for building contractors, trucking companies, multimedia leasing firms and a number of other businesses in almost all sectors of the economy. Eliminating cascading for a particular firm may cost several million dollars. Systematically eliminating cascading, however, may cost as much as $350 to $400 million.

It may be worthwhile to approach fixing the MBT from both a systematic and an ad hoc basis balancing the need for highly specific fixes with the need to address fundamental problems with the tax. policy makers should be cognizant of the costs associated with making a specific fix. To the extent that a specific fix is adopted more systematic reform is made less likely as fiscal resources are consumed. In short, the next credit, of what ever form, should be balanced with the need for obvious and fundamental reform of the tax. For example, phasing out the surcharge over time, removing sales tax from the base of gross receipts and increasing the compensation limit under the small business credit should be preferred to specialized and esoteric ad hoc fixes to the tax. This policy does not preclude specific and limited fixes and credits but gives far greater weight to systematic and equitable changes to the law.

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The following indicates the cost associated with making various changes to the MBT.

Policy Change	Cost (In Millions)
Elimination of Surcharge	$687
Elimination of Taxes from Gross Receipts	$75
Elimination of Cascading	$350 -$400
1st year cost of 3 year surcharge elimination	$128.8
Removing "bad debts" from the gross receipts base	$23
Increasing the compensation limit for the small business credit to $250,000 to deal with the unitary impact on small business.	$120 (fiscal 07-08) $188 (fiscal 08-09)
Increasing the compensation limit for small business credit to $250,000 and applying business income tax of 5% to offset cost.	$96 (fiscal 07-08) $151 (fiscal 08-09)

The above estimates are subject to change and have been obtained from the Michigan Department of Treasury or the Senate Fiscal Agency. Estimates of other changes to the law have been requested and are forthcoming.